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CHAPTER TWO

CORPORATE GOVERNANCE

This chapter describes the basic governance mechanisms of the corporation: the board of directors and top management. These are the people who are primarily tasked with the strategic management process if the corporation is to have long-term success in accomplishing its mission. The responsibilities of both are described and explained. It proposes a board of directors' continuum on which boards can be placed in terms of their involvement in strategic management. Agency theory is contrasted with stewardship theory. The chapter explains how the composition of the board can affect both its performance and that of the corporation. It also describes the impact of the Sarbanes–Oxley Act on corporate governance in the United States and trends in corporate governance around the world. Top management is discussed in terms of executive leadership, strategic vision, and managing the strategic planning process.

LEARNING OBJECTIVES

1. Describe the role and responsibilities of the board of directors in corporate governance.
2. Explain how the composition of a board can affect its operation.
3. Describe the impact of the Sarbanes–Oxley Act on corporate governance in the United States.
4. Discuss trends in corporate governance.
5. Explain how executive leadership is an important part of strategic management.

TOPICS OUTLINE COVERED

1. Role of the Board of Directors
    a. Responsibilities of the Board
2. Board of Directors Composition
    a. Nomination and Election of Board Members
    b. Organization of the Board
3. Impact of the Sarbanes–Oxley Act on U.S. Corporate Governance
    a. Improving Governance
    b. Evaluating Governance
    c. Avoiding Governance Improvements
4. Trends in Corporate Governance
5. The Role of Top Management
    a. Responsibilities of Top Management

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SUGGESTED ANSWERS TO DISCUSSION QUESTIONS

2-1. What are the roles and responsibilities of an effective and active Board of Directors?

The board of directors is required by law to direct the affairs of the corporation, but not to manage them. Stuart has written that a board is responsible for (1) effective leadership, (2) strategy of the organization, (3) the balance of risk and initiative, (4) succession planning, and (5) sustainability. The role of the board is to carry out three basic tasks: (1) monitor; (2) evaluate and influence; and (3) initiate and determine.

2-2. What are the issues that suggest the need for oversight of a particular company's management team?

The board of directors holds the top management team responsible for implementing and guiding the strategy set forth. There are several red flags that would indicate the need for oversight of a management team. When the corporate objectives are not being met, management teams may be at fault. When a clear vision is not articulated, the CEO must be responsible. Also, when the strategic planning process is not being monitored by the top management team, oversight may be called for.

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2-3. What is the role of a board of directors?

By law, when a company incorporates, it must have a board of directors—even if the stock is held only by the founder and his/her spouse. However, the rationale for the board of directors seems to be changing from simply one of safeguarding stockholder investments to a broader role of buffering the corporation from its task environment and forcing management to manage strategically. This change is the result of increased pressure from institutional investors and other shareholders together with society in the form of special interest groups. Each stakeholder seeks to maximize their objective, whether it be greater profits, a special environmental or sustainability goal, or some other agenda. In response to this pressure, boards of directors are taking more active roles in the strategic management of corporations, and in some cases are actively involved in shaping company strategy. For shareholders, good corporate governance increases the likelihood of greater profitability, however special interest groups expect that boards of directors will balance the desire for higher profits with the social needs of society. The board's connections to key stakeholders in the corporation's task environment can also provide invaluable information for strategic decision making. This is the main reason why advisory boards are often used by companies that are not incorporated and thus have no shareholders. If nothing else, the board can do the corporation a great service by simply offering top management a different point of view.

2-4. Who should and should not serve on a board of directors? What about environmentalists or union leaders?

This is a wide-open question with no simple answer. Some may argue that representatives from each stakeholder group in the corporation's task environment should be included so as to keep top management aware of key environmental considerations. Others may argue that only outsiders with no personal stake in the corporation (e.g., not a member of a local bank or a key supplier) would be best able to bring the amount of objectivity needed to help make strategic decisions. This is the point of view taken in the United States by the Sarbanes–Oxley Act. A good argument can be started by suggesting that a representative from labor be a director. This is done in Germany. If this makes some sense, who should it be—a union member who is an employee of the corporation or an employee of another corporation? If the firm is not unionized, what then? Further discussion can be generated by suggesting that the composition of the board reflects the key demographics of the corporation's workforce in terms of race, sex, and age. Environmentalists could provide excellent information to top management, but could be a problem if they argue only for environmental considerations without regard to the corporation's other stakeholders.

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This question provides the instructor with the opportunity to get the class involved in a discussion of agency and stewardship theories. *Agency theory* suggests that insiders should be kept to a minimum and that the board be heavily composed of objective outsiders who own large blocks of stock. Because of their stake in corporate decisions, affiliated directors would not be considered for board membership. This would ensure that the board would primarily represent shareholder interests and objectively monitor the "hired hands" serving as top management. This is the point of view taken by the Sarbanes–Oxley Act in the United States. In contrast, stewardship theory views top management as concerned "stewards" of the corporation—people who may have a greater concern for the corporation as a whole and its survival than do the shareholders, and who may only be interested in earnings per share and little else. *Stewardship theory* suggests that the board should be composed of people who can provide important information from the task environment and valuable insight to top management. It would work to consider interests beyond shareholder value.

2-5. Should a CEO be allowed to serve on another company's board of directors? Why or why not?

The majority of outside directors are active or retired CEOs of other corporations. The chapter states that the average board member of a U.S. Fortune 500 firm serves on three boards and that only 40% of U.S. boards limit the number of directorships a board member may hold in other corporations. CEOs from other firms are highly valued because they can provide excellent advice to the CEO. Having a CEO from another firm serve on a corporation's board of directors results in an interlocking directorate between the two corporations. The text points out that this is a good way to obtain inside information about an uncertain environment and objective expertise about potential strategies

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and tactics. For these and other reasons, well-interlocked firms are better able to survive in a highly competitive environment. This is a good reason for allowing a firm's CEO to serve on the boards of other companies. The CEO is likely to bring back information and contacts that can be very useful to the corporation.

There is a down side, however, to allowing a CEO to sit on the boards of other firms. For one thing, serving on another company's board requires time and energy devoted to something other than the job he/she is paid to fulfill. Given the increasing pressure placed on board members, such service is becoming increasingly onerous. Because of this, the typical CEO now sits on only one board in addition to his/her own—down from two additional boards in the 1990s. Consequently, a board should work closely with its CEO to decide which other boards are most useful to the company for the CEO to join.

2-6. What would the impact be if the CEO was also the Board Chair?

Members of a board of directors who are outsiders tend to be more objective and critical of corporate activities. In that capacity they may provide greater oversight as compared to insiders, thereby encouraging better corporate governance and better performance. However, stewardship theory makes the case that senior executives identify with the corporation and its success and are thereby more focused on ensuring its future. In either case, it would seem that a clear danger exists in firms where the CEO is also the Board Chair in that necessary oversight could be compromised especially when there is no time limit for board members. In a staggered board situation, there would be little means of limiting the power of the CEO when the CEO is also the Board Chair.

2-7. Should all newly installed CEOs be transformational leaders? Would you like to work for a transformational leader?

According to the text, top management must successfully handle two responsibilities that are crucial to the effective strategic management of the corporation: (1) provide executive leadership and a strategic vision and (2) manage the strategic planning process. The text further argues that successful CEOs often provide this executive leadership by taking on many of the characteristics of the transformational leader by communicating a clear strategic vision, demonstrating a strong passion for the company, and communicating clear directions to others. Such transformational leaders, such as Bill Gates at Microsoft, Steve Jobs at Apple, and Anita Roddick at The Body Shop, have been able to command respect and energize their employees. They not only articulated a strategic vision, but they also presented a role for others in the company to identify with and follow. Their communication of high-performance standards coupled with their confidence in their fellow employees often raised performance to a high level. Nevertheless, such transformational leaders can be very difficult to work for and their overconfidence may even get the firm in trouble. Their forcefulness may drive other competent people away when they fail to allow for differences of opinion. Hint to the instructor: Once the class has discussed the pros and cons of transformational leaders, ask them how many would like to work for such an executive? Use Donald Trump as an example ("You're fired!"). You may be surprised by the number of people who would *not* like to work for such a CEO.

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ADDITIONAL DISCUSSION QUESTIONS FOR INSTRUCTORS

These are not found in the text and may be used by the instructor for classroom discussion or exams.

A2-1. What recommendations would you make to improve the effectiveness of today's boards of directors?

The following are among the many suggestions often made:

- Add more outsiders (people not affiliated with the corporation) to the board of directors. Keep the percentage of insiders (typically top management) to less than 50% of board membership.
- Separate the positions of CEO and Chairman so that top management cannot unduly influence the board's meetings and agenda. This should improve the board's ability to properly evaluate top management. If the Chair can't be separated from the CEO, select a Lead Director from among the outside directors.
- Use a committee composed of outsiders to nominate potential new directors. This will help to ensure that potential members are not friends of top management who may owe more allegiance to the CEO than to the shareholders.
- Nominate people to the board who have knowledge valuable to the board and who have expertise of value

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to top management. These should be people who will have the respect of top management and who can both advise and criticize top management as needed. Make sure that they are diverse in terms of background and experience.
- Require board members to own substantial amounts of stock in the corporation to ensure that they have a personal as well as professional stake in the welfare of the corporation.
- Allow shareholders to nominate people for election to director.

A2-2. Is there a conflict between agency theory and the concept of organizational stakeholders?

Agency theory is concerned with problems that occur in relationships between principals (owners) and their agents (top management). Because agents are, in effect, "hired hands," their interests are not usually aligned with those of the owner (stockholders) of a corporation. Consequently, agency theory is primarily interested in ways to better align these two sets of interests, such as management owning significant shares of stock or having a strong financial stake in the long-term performance of the corporation via long-term incentive plans. This helps to ensure that management looks beyond selfish short-term benefits of a decision to the more strategic issues that concern stockholders. The *concept of organizational stakeholders*, in contrast, looks at more than just owners and managers. It argues that groups other than stockholders and top management have a significant stake in the actions of the corporation and need to be considered in strategic decisions. What might benefit owners and management might hurt employees, the local community, or the environment. The concept of stakeholders thus proposes that the suggestions of agency theory are incomplete and insufficient to ensure that top management deals fairly not only with stockholders, but also with the needs of all concerned stakeholder groups. As it is currently defined, agency theory is more in agreement with Milton Friedman's narrow view of the responsibilities of a corporation than with the stakeholder view more common to concerns of social responsibility. (See Chapter 3 for Friedman's view of corporate responsibility.) This could change if society begins to consider top management not only as direct agents for stockholders, but also as indirect agents for other groups with a stake in the corporation's activities. Agency theory could thus be expanded to include the concerns of other interested groups and thus incorporate the stakeholder approach.

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SUGGESTIONS FOR STRATEGIC PRACTICE EXERCISE

The end of chapter exercise asks the student to evaluate the "best" and the "worst" manager for whom the student has worked. The questionnaire is based on the concept of French and Raven's "bases of power." This concept is usually discussed in Introduction to Management as well as in Organizational Behavior textbooks as a part of their discussion of leadership. You may need to briefly explain what each base means as part of your discussion of their scores. Briefly, *reward power* is based on someone's ability to give another something that is valued for doing what the other person wants. *Coercive power* is based on someone's ability to give someone something that is disliked if the other person does not do what is desired. *Legitimate power* is like authority in that it is based on one person's belief that another person has the right to ask him/her to do something. *Referent power* is like charisma in that it is one person's ability to get others to identify with him/her and to want to be like that person. *Expert power* is based on a person's knowledge or abilities in an area that is important for job performance and that the person is willing to share with someone else.

List the five bases of power on the board. Ask around five members of the class to provide you with their scores for their "best manager" on each of the bases. Write their totals under each of the five bases on the board and then calculate the average for each base. Do the same thing for the same five students for their "worst boss." In most instances, the average "best boss" will score higher than the average "worst boss" on referent, expert, and reward power, and lower on coercive and legitimate power. Because the "best manager" tends to have many of the characteristics of the transformational leader, this questionnaire provides some interesting information to use in answering the discussion question: *Would you like to work for a transformational leader?*

ADDITIONAL TEACHING MODULE

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CORPORATE GOVERNANCE STYLES

Just as boards of directors vary widely on a continuum of involvement in the strategic management process, so do top management teams. For example, a top management team with a low involvement in strategic management will tend to be functionally oriented and will focus its energies on day-to-day operational problems; this type of team is likely either to be disorganized or to have a dominant CEO who continues to identify with his or her old division. In contrast, a top management team with high involvement will be active in strategic planning. It will try to get division managers involved in planning so that top management will have more time to scan the environment for challenges and opportunities.

Both the board of directors and top management can be placed on a matrix that reflects four basic styles of corporate governance.

Styles of Corporate Governance

Degree of Involvement by Top Management		Low	High
	High	Entrepreneurship Management	Partnership Management
	Low	Chaos Management	Marionette Management

Degree of Involvement by Board of Directors

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Chaos Management

When both the board of directors and top management have little involvement in the strategic management process, their style is referred to as *chaos management*. The board waits for top management to bring it proposals. Top management is operationally oriented and continues to carry out strategies, policies, and programs specified by the founding entrepreneur who died years ago. The basic strategic philosophy seems to be, “If it was good enough for old J.B., it’s good enough for us.” There is no strategic management being done here.

Entrepreneurship Management

A corporation with an uninvolved board of directors but a highly involved top management has *entrepreneurship management*. The board is willing to be used as a rubber stamp for top management’s decisions. The CEO, operating alone or with a team, dominates the corporation and its strategic decisions. An example is Control Data Corporation under the leadership of its founder, William C. Norris. For 29 years, Norris dominated both the company’s top management and its board of directors. Insisting that the company could profit by addressing “society’s unmet needs,” Norris directed corporate investments into the rejuvenation of ghettos and support of wind-powered generators and tundra farming, among other projects. Although these investments tended to result in losses, few people were willing to challenge his strategic decisions. Some employees even referred to him as “the Pope.” A former Control Data executive noted, “More often than not, he’s proven his critics wrong, so now his visions aren’t challenged.”

Marionette Management

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Probably the rarest form of strategic management style, *marionette management* occurs when the board of directors is deeply involved in strategic decision making, but top management is primarily concerned with operations. Such a style evolves when a board is composed of key stockholders who refuse to delegate strategic decision making to the president. The president is forced into a COO role and can do only what the board allows him/her to do. This style also occurs when a board fires a CEO but is slow to find a replacement. The COO or executive vice-president stays on as "acting" president or CEO until the selection process is complete. In the meantime, strategic management is firmly in the hands of the board of directors.

Marionette management occurred at Winnebago Industries when the company's board of directors, chaired by its founder, 72-year-old John K. Hanson, took away Ronald Haugen's title as chief executive officer but left him as company president. No new CEO was named. Hanson, whose family owned 46% of Winnebago's stock, had given up the CEO title in 1983 to President Haugen, a long-time employee. Outside observers noted that although Chairman Hanson did not also hold the title of CEO, he appeared to have taken on the CEO's responsibilities once again.

Partnership Management

Probably, the most effective style of strategic management, *partnership management* is epitomized by a highly involved board and top management. The board and top management team work closely to establish the corporate mission, objectives, strategies, and policies. Board members are active in committee work and utilize strategic audits to provide feedback to top management on its implementation of agreed-upon strategies and policies. This appears to be the style in a number of successful corporations such as Texas Instruments, Target, and General Electric Company.

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